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DO YOU HAVE AN EXIT PLAN?

(*Business Advisory No. 17)*

This Advisory discusses the importance of creating a plan to transfer your business to your children, employees or third parties at the time of your retirement, death or disability. Without a business exit plan, it is likely that estate taxes will undermine the continuing viability of your business. Implementation of such a plan takes years once it is started. We look forward to assisting you in combining legal and tax strategies with estate planning to provide a practical and feasible exit plan.

This Advisory is neither exhaustive nor tailored to your specific situation, but only intended to give you enough information to discern whether these are options you may want to consider in implementing an exit plan for your business. Our Firm's representation is only undertaken through a written engagement letter and not by the distribution of this Advisory.

Need for Exit Plan. You have probably worked hard to build your business, but have you thought about what will happen if you need to retire due to a medical situation or at your death, when you are no longer able to make decisions about your business? According to a recent study in the *Small Business Review*, only 30% of all family-owned businesses survive to the next generation; only 12% make it to the third generation, and a meager 3% are functioning into the fourth generation and beyond. Why? Most business owners simply do not plan an exit strategy. They do not do proper estate planning, which often results in unnecessary estate taxes that drain the life out of their businesses. A successful transition to the next generation requires a plan.

Exit Plans. A business continuity plan is a method that involves a variety of transfer events and sequences that impact the business and the remaining or new owner when the original owner leaves or dies. Usually this is accomplished with a Buy-Sell Agreement which provides for an orderly transition of ownership interest when various stated events occur. Several options should be planned for, and each can have a different plan, such as a temporary disability, permanent disability, death of one or all business partners, bankruptcy, or your retirement and transfer of business operations to other individuals. This involves some thoughtful consideration of who could take over your business, especially if you are the sole operator or the key talent that makes your business run smoothly. You may have more choices than you think, so let's look at transfers to family members, business partners, or employees; sales to third parties; or possible transfers to a charity.

Family members are often a logical choice, especially if you already have a child that works with you in the family business. Depending on your financial needs, you can gift and/or sell your business to family members. Some techniques will provide you with retirement income and let you transfer the business at a discount, saving estate and gift taxes. You may be able to retain some control, too.

Be sure to consider family members who will not be involved with the business. Life insurance is often used to "equalize" inheritances by allowing children who have no interest or ability to operate the family business to receive a cash lump sum rather than force two siblings who may not agree on business decisions or strategies to operate the family business. You need to be objective when considering the abilities of family members whom you consider potential successors – some may have experience in business and financial matters and others may be overwhelmed by taking on this responsibility.

Business partners are also logical options. You can have a reciprocal Buy-Sell Agreement with each other so that when one of you is ready to retire or dies, the other automatically buys his or her share of the business, with the surviving spouse, trust, or estate receiving the sale proceeds. Life insurance is often used to fund these arrangements. Without a plan, you may find yourself in business with your partner's spouse, children or other beneficiaries at the partner's death. This may be acceptable in some situations and not such a great arrangement for others. If your partner's marriage is dissolved, or if he or she becomes incompetent, or is convicted of a crime, your business and your relationship can also be adversely affected. If you fail to plan for potential unforeseen events, you will bring added stress if you must deal with them during a time of crisis.

Your employees could also be an alternative. An Employee Stock Ownership Plan lets your employees enjoy the benefits of ownership, yet you can keep control of your business until your retirement or death.

How about a charity? Charitable trusts can provide terrific income, capital gain and estate tax savings if your children or employees are not interested or able to continue the business. With a charitable remainder trust, you can receive a lifetime income, get a great tax deduction, and have the added benefit of helping a charity that has special meaning to you.

Outside parties or companies are also an option that can result in an outright sale at the triggering event; however, the tax benefits are usually not as good as other planning options.

The benefits of having an exit plan for your business include the following:

- Allows the remaining owners to determine with whom they will work and share control of the entity
- Prevents outsiders or heirs, whose interests may conflict with the entity or the remaining owners, from obtaining an ownership interest

- Ensures continuity of management and control by the remaining owners
- Increases job stability for minority owners and key nonowner employees
- Provides for the orderly liquidation of the owners' interests when a triggering event occurs
- Prevents the continued involvement in the business of retired or inactive owners
- Creates a market for the shares of the deceased, retiring or withdrawing owner
- Generates cash to pay death taxes and estate settlement costs
- Fixes the value of the interest for estate and gift tax purposes
- Prevents the loss of an S corporation election by preventing a transfer of the interest to an unqualified shareholder (i.e. a corporation) or to a shareholder who refuses to elect S corporation status

Consideration for a Plan. What components must be addressed when creating an exit plan? Here are some objectives to consider and evaluations you need to make before a plan can be implemented:

1. Evaluate how much longer you want to work in the business until retiring.
2. Determine how much annual after-tax income you want during retirement, in today's dollars.
3. Determine who you want to transfer the business to – family, co-owner, key employee, charity or outside party? If you anticipate the business passing to a family member, evaluate possible problems in family relationship issues and whether the person will be sufficiently prepared to take over the business.
4. Determine the estimated current value of your business and your personal financial situation. If the business is operated by someone with a professional license, additional factors must be viewed, as transfers may be restricted to family members who do not hold such a license.
5. Evaluate estimated estate tax and potential gift tax repercussions in various scenarios that could be implemented.
6. Determine if separate property or community property interests are at issue, or whether a domestic partner's interest or claim may impact an exit plan.

7. Determine whether an existing estate plan is in place and how an exit plan will alter an estate plan; if no estate plan exists, then it will need to be addressed simultaneously with the creation of an exit plan.

8. Determine whether mandatory buy-out terms for a partner might impact the reserves of a business; if so, the cost of insurance policies should be evaluated.

As you can see from the above list, some of these determinations will require the assistance of professionals such as attorneys, tax accountants, and insurance agents. In some instances, it may be beneficial to have a psychologist/coach meet with family members and discuss family dynamics and the impact of the transition of a business from one generation to the next. It all depends on the complexity of the business and of the family relationships.

What happens if you fail to plan? Your spouse, family members and business partners will be left to deal with a myriad of dilemmas at a time when they are likely dealing with emotional issues after your death. Without a plan, your spouse or children may have to deal with the loss of income and continued operation of the business, along with debts and ongoing expenses. If you are the key talent or the sole owner of the business, your death may impact the salability of the business, resulting in greater financial problems for your survivors. You can avoid these problems by considering and implementing a plan while you are alive and able to make choices that are advantageous to you and your beneficiaries.

Conclusion: At some point, every owner leaves his or her business – either voluntarily or otherwise. At that time, every owner wants to receive the maximum amount of money possible in order to accomplish their own personal, financial, income and estate planning goals. An exit plan for a business owner is one of the greatest gifts you can leave your spouse, children or business partner.

A typical exit plan would include evaluation of existing estate planning documents, tax calculations, determination of life insurance needs and preparation of a Buy-Sell Agreement that sets out a plan for the transfer of ownership to business partners or family members, all designed to eliminate or reduce estate taxes. A typical Buy-Sell Agreement establishes a method to calculate future dollar values on the business to be paid by partners at the stated termination event (typically retirement, disability or death) or paid by an Employee Stock Ownership Plan, which allows employees to use collective funds to purchase the shares of a departing owner.

As always, you should be sure that additional legislation has not been enacted or that court decisions have been rendered that would change the above advisements. This Advisory is neither exhaustive nor is it tailored to your specific situation. If you have questions or concerns, you should discuss your individual situation with us or your own attorney. We look forward to being of assistance to you.

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This Advisory is one of a series of business and tax advisories prepared by the attorneys at Buynak, Fauver, Archbald & Spray, LLP. Should you have further questions regarding the information provided in this Advisory, please contact the author listed above.

Buynak, Fauver, Archbald & Spray, LLP provides business legal services to individuals, business entities and non-profit organizations from entity formation and start up, through day-to-day operations and exit strategies.

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